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No. _____

In the Supreme Court of the United States

OCTOBER TERM, 1996

BERRY F. LAWS, III,
Successor Segregated Fund Trustee,
Petitioner,

v.

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The debtor in this case paid $4 million to a bank during the preference period, before the commencement of the debtor's bankruptcy case. The bank demanded the payment in order to extinguish a "negative collected funds" balance in the debtor's checking account; the negative balance was the result of a "check-kiting" scheme undertaken by the debtor. The $4 million payment presents two questions to this Court:

1. Whether the bank received more from the payment than it otherwise would have in a Chapter 7 liquidation, in violation of Section 547(b)(5) of the Bankruptcy Code, 11 U.S.C. § 547(b)(5); and

2. Whether such a payment constituted a transfer of the debtor's property on account of an "antecedent debt," within the meaning of Section 547(b)(2) of the Bankruptcy Code, 11 U.S.C. § 547(b)(2).

LIST OF PARTIES

The parties to the proceedings below were Petitioner Berry F. Laws, III, Successor Segregated Fund Trustee, and Respondent United Missouri Bank of Kansas City, N.A.

Petitioner Berry F. Laws, III, is the Successor Segregated Fund Trustee under a confirmed Chapter 11 plan of reorganization for Kroh Brothers Development Company, et al. and, as such, is the bankruptcy court-appointed fiduciary of the creditors under such plan, which consist primarily of approximately 1,700 creditors holding unsecured claims of approximately $105 million in the aggregate.

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PETITION FOR A WRIT OF CERTIORARI

The Petitioner Berry F. Laws, III, Successor Segregated Fund Trustee, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit.

OPINIONS BELOW

The October 21, 1996 opinion of the Court of Appeals (App., *infra*, 1a-11a) is reported at 98 F.3d 1047. The November 26, 1996 Order of the Court of Appeals denying Petition for Rehearing and Suggestion for Rehearing En Banc (App., *infra*, 12a) is not reported.

The opinion of the district court (App., *infra*, 13a-34a) is reported at 188 B.R. 263.

JURISDICTION

The Court of Appeals judgment and opinion was entered on October 21, 1996, and a timely Petition for Rehearing and Suggestion for Rehearing En Banc was filed on November 4, 1996, which was denied on November 26, 1996.

The jurisdiction of this Court to review the judgment of the Court of Appeals arises under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

This case involves consideration of the preferential transfer provisions under Section 547 of the Bankruptcy Code, 11 U.S.C. § 547 (1986), and other related Bankruptcy Code provisions, including the definitions of "debt" and "claim" set forth in Section 101 of the Bankruptcy Code, 11 U.S.C. § 101, and the provision governing recovery of avoided transfers, 11 U.S.C. § 550. The text of these statutory provisions is set forth in the Appendix hereto (App., *infra*, 35a-41a).

STATEMENT OF THE CASE

Kroh Brothers Development Company ("Kroh") was a Kansas City, Missouri-based real estate syndication company

that was once successful, but subsequently experienced financial difficulties and became insolvent.

Kroh perpetuated a check-kiting scheme, depositing checks drawn on one bank in an account at another bank, even though the account on which the checks were drawn did not have sufficient funds to cover the checks. The purpose of such a scheme is to obtain "provisionally credited funds" in the second account for a short period of time.[1] By taking advantage of bank policies allowing it to write checks on uncollected deposits, Kroh was able to use its accounts at three area banks effectively to borrow funds represented by "negative collected funds" balances in its various accounts.

United Missouri Bank of Kansas City, N.A. ("UMB") was one of the three banks whose accounts Kroh used in perpetuating its check-kiting scheme. UMB, as a result of having a director who was also a controlling shareholder of Kroh, was also a statutory "insider" of Kroh for Bankruptcy Code purposes. C.A. App. 158-64.

Kroh's check-kiting scheme produced substantial negative collected funds balances in its UMB checking account.[2] C.A. App. 503, 628-650. Such "uncollected funds" balances

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[1] A description of a typical check-kiting scheme can be found in *Williams* v. *United States*, 458 U.S. 279, 281 n.1 (1982). Kroh's scheme differed from the description contained therein in that Kroh perpetuated the scheme among three, instead of two, banks.

[2] The collected funds balance reveals the actual balance of funds collected from deposits. Immediately after checks are deposited into a bank account, the collected funds balance will temporarily be lower than the ledger balance, which assumes immediate collection of deposits. The discrepancy is usually remedied once the clearance process has been completed (except in the case of bad checks), but check kiting is designed to take advantage of that discrepancy by capitalizing on the delays in the check-clearing process.

came to the attention of senior executives of UMB, in part through the use of check-kiting detection software. C.A. App. 607-611, 679-682, 689, 726-745. UMB senior executives considered the negative balances to be an unsecured loan. C.A. App. 509-510, 516, 519. The executives first decided to have UMB charge Kroh interest on the uncollected balances (C.A. App. 505, 523-524, 525-529), which Kroh agreed to pay. C.A. App. 520; see also 522-524; 530-554. Then UMB decided that the bank would no longer permit Kroh to maintain any uncollected balances at UMB and demanded that Kroh provide UMB with "good funds". C.A. App. 564, 512-513, 555-557, 565-566. Kroh complied with that demand by paying UMB $4 million on October 20, 1986 with part of the proceeds of a general $7 million loan from Commerce Bank, another Kansas City bank. C.A. App. 627. As a result of that $4 million payment, Kroh owed UMB no material indebtedness at the time it filed for bankruptcy on February 13, 1987.

Other creditors were not so fortunate. Under Kroh's confirmed plan of reorganization, the unsecured creditors Petitioner represents — whose claims aggregate approximately $105 million — were originally expected to receive no more than twenty-five percent of their claims; but they will actually receive substantially less than that. These creditors include numerous banks and other financial institutions.

The underlying suit was brought against UMB to avoid the $4 million payment as a preferential transfer under Section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b). (Federal jurisdiction in the District Court was based on 28 U.S.C. § 1334.) UMB eventually moved for and was granted summary judgment by the District Court on the ground that the $4 million transfer did not enable it to improve its position in violation of Section 547(b)(5) of the Bankruptcy Code because it was, in the opinion of the District Court, a fully secured creditor by virtue of its statutory security

interest in the checks deposited in connection with the check-kiting scheme. (App., *infra*, 27a-28a).

On appeal, the Court of Appeals affirmed the District Court's grant of summary judgment in favor of UMB. The Court of Appeals affirmed the District Court's holding that the $4 million transfer did not permit UMB to improve its position in violation of 11 U.S.C. § 547(b)(5).

REASONS FOR GRANTING THE WRIT

Petitioner seeks to avoid the October 20, 1986 $4 million payment to UMB under the preference section of the Bankruptcy Code, 11 U.S.C. § 547.[3] That statutory provision generally permits a court-appointed representative of a debtor's bankruptcy estate to avoid transfers of the debtor's property that were made shortly before bankruptcy on account of "antecedent debts," if the transfers had the effect of improving the position of the beneficiary of the transfer at the expense of other similarly-situated creditors of the debtor.[4] As such, the preference section promotes a "central policy of the Bankruptcy Code," *i.e.*, equality of distribution, *Begier* v. *Internal Revenue Service*, 496 U.S. 53, 58 (1990).[5]

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[3] Technically, a preferential transfer is *avoided* pursuant to Section 547(b) of the Bankruptcy Code, but, once avoided, is *recovered* pursuant to Section 550(a) of the Bankruptcy Code, see App., *infra*, 56a.

[4] The preference section generally applies to transfers of the debtor's property made within ninety days prior to the commencement of the debtor's bankruptcy case, unless the transfer is to or for the benefit of an insider; in the latter case, the preference period is one year prior to the commencement of the bankruptcy case. 11 U.S.C. § 547(b)(4). Because UMB was an insider of Kroh, the one-year preference period applies.

[5] As this Court stated in *Begier*:

The Bankruptcy Code's "central policy" of equality of distribution is directly implicated in this dispute. UMB, an insider of Kroh, had experienced an unfavorable change in its banking relationship with Kroh and had become increasingly concerned over the extent of its exposure to Kroh at a time when Kroh was clearly insolvent. Within the pertinent preference period, UMB demanded and received "good funds" extinguishing that exposure. Those funds were found in the $4 million transfer at issue here. No other creditor shared in that transfer. Kroh thus favored UMB (an insider) over its other unsecured creditors, and the others suffered for it. Unlike UMB, which had no material claim against Kroh upon the commencement of its bankruptcy case, other creditors were owed approximately $105 million and will not receive more than twenty-five percent of their undiscounted claims. UMB's favored position in this respect was solely a result of the challenged transfer.

> Equality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property. See, *e.g.*, 11 U.S.C. § 726(b) (1982 ed.); H.R. Rep. No. 95-595, [*infra*], at 177-178. Section 547(b) furthers this policy by permitting a trustee in bankruptcy to avoid certain preferential payments made before the debtor files for bankruptcy. This mechanism prevents the debtor from favoring one creditor over others by transferring property shortly before filing for bankruptcy.

496 U.S. at 58. As the legislative history cited in *Begier* points out, the preference section furthers this central policy of equality of distribution in two ways: by requiring creditors who were preferred during the pertinent preference period to "disgorge so that all may share equally," and by creating a disincentive for creditors to attempt to dismember a debtor's estate as the debtor begins its slide into bankruptcy. H.R. 595, 95th Cong., 1st Sess. 177-178 (Sept. 8, 1977), reprinted in 1978 U.S.C.C.A.N. 6138.

Thus, the challenged $4 million transfer bears all of the earmarks of a preferential transfer. Yet the Court of Appeals upheld the District Court's grant of summary judgment, holding that the $4 million payment did not permit UMB to "improve[ ] its position" (in the Eighth Circuit's terms). See App, *infra*, 10a-11a. The Court of Appeals held that UMB was a fully secured creditor by virtue of its state law statutory lien in the checks that were deposited as part of the check-kiting scheme, even though those checks were, as a practical matter, worthless.

The Eighth Circuit's holding is inconsistent with the express language of the Bankruptcy Code, and with the approach taken by courts of appeals in other circuits. The Eighth Circuit's application of a formalistic improvement-of-position test, without regard to how the creditor would fare in a hypothetical Chapter 7 proceeding, is irreconcilable with the statute. No other circuit has adopted such a rule. Moreover, the Court of Appeals was apparently influenced by a policy concern that runs counter to established authority of this Court, and is already adequately addressed in the statute through an express statutory exception for transactions in the ordinary course of business. See 11 U.S.C. § 547(c)(2); App, *infra*, 37a. Finally, the Eighth Circuit held — contrary to the law in at least two other circuits — that routine advances against uncollected balances can never constitute a "debt" for preference purposes.

I. THE COURT OF APPEALS IGNORED THE STATUTORY STANDARD FOR DETERMINING AVOIDABLE PREFERENCES.

The Court of Appeals held that UMB had not improved its position as a result of the $4 million transfer because it had a security interest in the kited checks and their proceeds. According to the Eighth Circuit's reasoning, that security interest rendered UMB a fully secured creditor because UMB ultimately collected on such checks.

The Court of Appeals reached its conclusion without reference to the express statutory standard set out in Section 547(b)(5). That provision defines an avoidable transfer as one that enables a creditor to receive more as a result of the transfer than it would have received in a hypothetical Chapter 7 proceeding (and in the absence of the transfer).[6]

Thus, Section 547(b) requires the court to compare the benefit resulting from the challenged transfer with the transferee's situation had it been required to forego the transfer and proceed to liquidation of the bankruptcy estate.

1. The Court of Appeals contravened the most fundamental principles of statutory construction by ignoring the plain meaning of the statutory language. See, *e.g.*, *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-254 (1992) ("courts must presume that a legislature says in a statute what it means and means in a statute what it says there * * * . When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete'" (citation omitted)); *United States* v. *Ron Pair Enterprises*, 489 U.S. 235, 240-241 (1989) ("as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute"). By its terms, the statute requires a reviewing court to compare the transferee's situation with the result of a hypothetical Chapter 7 proceeding. The Eighth Circuit here made no effort to comply with that simple statutory command.

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[6] Section 547(b)(5) of the Bankruptcy Code sets forth a hypothetical test: assuming that all of the other elements of 11 U.S.C. § 547(b) are satisfied, a transfer is preferential if it "enables such creditor to receive more than such creditor would receive if — (A) the case were a case under chapter 7 of [the Bankruptcy Code]; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of [the Bankruptcy Code]." 11 U.S.C. § 547(b)(5).

If the transfer in this case had not occurred — *i.e.*, if the October 20, 1986 payment had not been made to UMB but those $4 million in proceeds of the $7 million Commerce Bank loan had been used to pay another creditor instead of UMB — the kite would have eventually collapsed, UMB would have had a $4 million unsecured claim as of the commencement of the bankruptcy case, and UMB would not have received payment in full of that claim in a hypothetical Chapter 7 liquidation of an insolvent Kroh.

That UMB's claim would actually be unsecured in such an instance is easily demonstrated by a consideration of what would happen with respect to UMB's "collateral" in a hypothetical Chapter 7 liquidation of Kroh. In a hypothetical Chapter 7 liquidation of Kroh, UMB would first be required to realize upon its collateral, the deposited checks, in order to satisfy its $4 million claim arising from the negative uncollected balance in the UMB checking account. See *In re SPM Mfg. Corp.*, 984 F.2d 1305, 1312 (1st Cir. 1993). Although UMB would have a statutory lien in the deposited checks under applicable state law, UMB would nonetheless realize nothing upon a liquidation of that collateral — the collateral, by its very nature, would be worthless because the deposited checks would not be supported by any actual deposits of good funds. Thus, after the application of the value of its collateral ($-0-) to its ostensibly secured $4 million claim, UMB would be left with a $4 million unsecured claim.

This is precisely the comparison mandated by the statute. See *In re Virginia-Carolina Financial Corp.*, 954 F.2d 193, 199 (4th Cir. 1992) ("a creditor need not return a sum received from the debtor prior to bankruptcy if the creditor is no better off *vis-a-vis* the other creditors of the bankruptcy estate than he or she would have been *had the creditor waited for liquidation and distribution of the assets of the estate*"

(citations omitted)) (emphasis supplied).[7] It is precisely what the Eighth Circuit failed to do.

Kited checks are worthless at the time they are presented, even though the fact of their worthlessness is not generally known until the kite collapses (which was prevented in this case by the very transfer in question). See *United States* v. *Sher*, 661 F.2d 34 (3d Cir. 1981) ("a kited check is 'overvalued' because it is represented to be worth its face value, when in fact it is worthless, since it is not supported by funds on deposit in the account on which the check is drawn"), cert. denied, 458 U.S. 1121 (1982); *Stevens* v. *United States*, 227 F.2d 5, 6 (8th Cir. 1955) (check kiting described as "cashing worthless checks to procure funds for deposit to cover previous checks, there being no reasonable prospect of paying"). The only way these checks obtain any value is when good funds are injected into the banking system. In this case, that did not incur until UMB insisted on the $4 million transfer in question.[8] The transfer depleted Kroh's bankruptcy estate by $4 million. See, *e.g.*, *In re*

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[7] The plain terms of the statute require that the valuation of the collateral be made *as of the date of the hypothetical liquidation*. See Countryman, *The Concept of Voidable Preference in Bankruptcy*, 38 Va.L.Rev. 713, 740-41 (1985) ("The logic of *Palmer Clay Products* [v. *Brown*, 297 U.S. 227, 229 (1936)] and of section 547(b) — both of which search for the effect of the transfer or what otherwise would have been a Chapter 7 distribution — indicates that the valuation of collateral should be made at the time of the Chapter 7 distribution") (emphasis supplied). As set forth above, a liquidation of UMB's collateral as part of such a Chapter 7 distribution would have produced nothing, let alone $4 million.

[8] The funds by which the kited checks were ultimately paid involved a new injection of capital (*i.e.*, $4 million on October 20) into the floating system of bad checks; these new funds were independent of and unrelated to the kited checks. Therefore, such new funds were not "proceeds" of the kited checks.

Smith, 966 F.2d at 1536-37 (because the debtor "could have purchased a yacht or acquired some other asset instead of paying his debt," the assets in the estate were less than they could have been).

A commonsense proof of the worthlessness of UMB's "collateral" is UMB's own actions. If UMB were fully secured by its possession of such checks, there would have been no need to demand, as it did, that Kroh provide it with "good funds". Indeed, the concept of "good funds" has no meaning if the checks were, in fact, collateral worth their face amount. However, they were not, and UMB recognized that through its demand for "good funds." The kited checks were worthless by definition and they remained so.

As the foregoing comparison demonstrates, UMB would have been significantly *worse off* "had [it] waited for liquidation and distribution of the assets of the estate" instead of demanding and receiving the challenged $4 million transfer. *In re Virginia-Carolina Financial Corp.*, 954 F.2d at 199. See also *In re Chattanooga Wholesale Antiques, Inc.*, 930 F.2d 458, 461 (6th Cir. 1991); *In re Erin Food Services, Inc.*, 980 F.2d 792, 801 (1st Cir. 1992). Thus, the October 20, 1986 transfer to UMB enabled UMB to receive more than it would have if there had been no transfer and Kroh had commenced a Chapter 7 liquidation. The transfer thus meets the standard of 11 U.S.C. § 547(b)(5).

2. The opinion below makes no effort to reconcile the foregoing analysis with its holding that UMB was a fully secured creditor under Missouri state law. That principle, which is correct as a matter Missouri state law, is simply not dispositive of the inquiry mandated by Section 547(b)(5). Missouri law offered a guarantee that UMB would have a security interest in the deposited checks and their proceeds. However, whether UMB would have a fully secured claim for Bankruptcy Code purposes would be determined not by the existence of a state law security interest, but by the value of UMB's collateral. See *Ron Pair Enterprises*, 489 U.S. at 239

(under the Bankruptcy Code, "a claim is secured only to the extent of the value of the property on which the lien is fixed; the remainder of that claim is considered *unsecured*") (emphasis supplied). As the foregoing proper application of 11 U.S.C. § 547(b)(5) demonstrates, if the check-kiting scheme had collapsed and Kroh had commenced a Chapter 7 liquidation, those checks would have been worthless and UMB's formal position as a secured creditor would have gained it nothing; it would have to compete with other unsecured creditors for satisfaction of its entire $4 million claim.

In short, the $4 million was made from funds that were independent of UMB's "collateral" (the kited checks), and constituted a transfer to a wholly undersecured creditor. It is black-letter bankruptcy law that "[p]ayments to a partially secured creditor from property not covered by its lien * * * have a preferential effect." 5 Collier on Bankruptcy ¶ 547.03[7], p.547-41 (15 rev. ed. 1996) See also *Porter v. Yukon Nat'l Bank*, 866 F.2d 355, 359 (10th Cir. 1989) (transfers to undersecured creditor found to be preferential). *Barash v. Public Finance Corp.*, 658 F.2d 504, 508-509 (7th Cir. 1981) (same).

Instead of undertaking the required statutory analysis, the Court of Appeals purported to analyze the Section 547(b)(5) issue in vague terms, asking whether the transfer improved UMB's position, without articulating any standard for judging that "improvement" (App., *infra*, 10a-11a). However, the foregoing application of the Section 547(b)(5) test demonstrates that the $4 million transfer depleted Kroh's bankruptcy estate and enabled UMB to recover more than it otherwise would have at the time of a hypothetical Chapter 7 liquidation. That is the test the Court of Appeals was obligated to apply. It is simply irrelevant that Missouri state law would have deemed UMB a secured creditor at the time of the transfer.

It is no answer to say (as the Court of Appeals implicitly did in this case) that the statutorily mandated comparison is irrelevant because the U.C.C. provides a remedy and would have rendered UMB a secured creditor. If the U.C.C. security interest would not have produced the same percentage distribution in a hypothetical Chapter 7 case (which, as demonstrated above, it would not have), then it does not avail the transferee. Put simply, what is at issue under Section 547(b)(5) is how liquidation would have turned out, not what the U.C.C. would say when divorced from the Bankruptcy Code.

3. In its decision, the Court of Appeals relied on non-statutory policy concern — that a contrary holding would complicate the administration of bankruptcy cases and disrupt the banking system by making any bank's payment against uncollected balances suspect as a preferential transfer (App., *infra*, 8a-9a). However, this Court has clearly held that courts may not rely on their own understanding of external policy considerations when interpreting the preference section. See, *e.g.*, *Union Bank* v. *Wolas*, 502 U.S. 151 (1991) ("The fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning") (citation omitted).

Moreover, it was unnecessary (as well as improper) for the court below to cast aside the plain language of Section 547(b)(5) out of a concern for the needs of the banking and bankruptcy systems — the Bankruptcy Code itself takes account of those concerns. Congress has already addressed the concern articulated by the Court of Appeals, providing an express statutory exception to preference recovery in 11 U.S.C. § 547(c)(2) for transactions in the ordinary course of business. Under that provision, banks routinely paying against uncollected funds, a practice common throughout the commercial banking industry, will normally be sheltered from

preference attack if the bank's customer subsequently becomes a bankruptcy debtor.

The Section 547(c)(2) defense for transactions in the ordinary course of business demonstrates how the transfer to UMB differs fundamentally from a routine ledger deposit that covers an uncollected funds position in a putative debtor's bank account. In order to be sheltered from preference attack under Section 547(c)(2), the transfer must be made in the ordinary course of business "in payment of a debt *incurred* in the ordinary course of business" of the transferor and transferee and must be made according to "ordinary business terms". 11 U.S.C. § 547(c)(2) (emphasis added). Here, Kroh was engaged in a check-kiting scheme. UMB was an insider of Kroh: UMB knew not only that Kroh had developed an increasingly large uncollected funds position, but also that Kroh might be engaged in a check kite. UMB first charged Kroh interest on the uncollected funds position, and then demanded that it be immediately provided with "good funds".

There is nothing "ordinary" about such a set of facts from the perspective of a typical banking relationship. They are, however, consistent with the paradigm example of a preference: an unsecured creditor — an insider to boot — becomes concerned about its mounting debt and demands that the putative debtor satisfy that debt immediately, with the effect that the transfer depletes the bankruptcy estate and that creditor is preferred over similarly-situated creditors.

Careful application of the Section 547(b) analysis would have demonstrated that the concerns expressed by the Court of Appeals are fanciful in any event. The underlying reality is that the overwhelming number of checks passing through the banking system, including those of putative bankruptcy debtors, are supported by good funds in the system. Thus, a depository bank with the benefit of a statutory lien would be able to recover on those checks in nearly every instance except where the depositor is engaged in a check-kiting

scheme. In nearly every case, then, application of the analysis mandated by Section 547(b)(5) would result in vindication of the Eighth Circuit's assumption: A fully secured creditor (the depository bank) would routinely be able to recover the amount of the deposited checks and would not have benefited from a transfer during the preference period. Check-kiting cases are the rare exception. A transfer such as the one at issue here — which was made in satisfaction of a negative collected funds balance created as a result of a check-kiting scheme — results in a preference to the depository bank and a corresponding detriment to other creditors. Such a transfer violates the purpose and express provisions of he preference statute. That should not (and need not) occur in order to address an extrastatutory policy concern that will never really be implicated because of, among other reasons, the presence of 11 U.S.C. § 547(c)(2).

4. The Court of Appeals here took a shortcut in applying Section 547(b)(5) that not only ignored the provisions of the statute, but produced a result directly opposed to the purpose of the statute. It compounded the error by preferring its own policy articulations to the clear requirements of the Bankruptcy Code. Thus, a writ of certiorari should be granted to settle the question of the proper application of 11 U.S.C. § 547(b)(5).

II. THE COURT OF APPEALS HELD THAT ROUTINE ADVANCES BY A BANK AGAINST UNCOLLECTED BALANCES COULD NEVER CONSTITUTE A "DEBT" FOR PREFERENCE PURPOSES, CONTRARY TO THE RULE ESTABLISHED IN AT LEAST TWO OTHER CIRCUITS.

The Court of Appeals affirmed the District Court's grant of summary judgment to UMB on the ground discussed above. It had earlier held, however, that routine advances against uncollected funds in a checking account do not create an antecedent debt for purposes of 11 U.S.C. § 547(b)(2). The Eighth Circuit held that UMB was not entitled to

summary judgment on that question because an issue of material fact existed as to whether UMB and Kroh had agreed to convert the negative collected funds balances into loans (App., *infra*, 8a-10a).

If the Court grants certiorari on the first question presented in this case, it should also grant the writ as to the definition of "debt" under Section 547(b)(2). The Eighth Circuit's holding on this question would be directly at issue if the Court reverses or vacates the ruling below on the ground that UMB improved its position by accepting the transfer. The holding of the Eighth Circuit on the definition of "debt" conflicts with the decisions of at least two other courts of appeals, and is inconsistent with the language of the statute and with this Court's directive concerning the definition of "claim," on which the definition of "debt" relies.

The Court of Appeals' holding is inconsistent with the plain meaning of the pertinent statutory provisions. The Bankruptcy Code defines "debt" to mean "liability on a claim." 11 U.S.C. § 101(12) (App., *infra*, 35a). The Bankruptcy Code, in turn, defines "claim" to mean "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured * * * ." 11 U.S.C. § 101(5)(A) (App., *infra*, 48a). See *supra*, at 7. Courts are to give this statutory definition of "claim" the broadest construction possible. *Johnson* v. *Home State Bank*, 501 U.S. 78, 83 (1991).

A bank that provides funds in spite of a negative collected balances position, particularly in the context of a check-kiting scheme, is extending credit to its customer, which gives rise to an immediate right to payment. See, *e.g.*, *United States* v. *LeDonne*, 21 F.3d 1418, 1419 (7th Cir.) (check kiting permits perpetrator "in essence, [to] obtain an interest-free loan"), cert. denied, 115 S. Ct. 584 (1994); *United States* v. *Stone*, 954 F.2d 1187, 1188 n.1 (6th Cir.

1992) (balance is "artificial", giving rise to claim); *Field* v. *Harrison*, 18 F.2d 729, 729 (2d Cir. 1927) (check kiting led to perpetrator being "indebted to each bank for the amount stated, notwithstanding [that] those amounts would not show upon the books of the bank until the checks were returned"). Thus, a right to payment exists on behalf of the bank in such a situation and that right of payment easily satisfies the unambiguous statutory definition of claim.

The Eighth Circuit's interpretation conflicts with holdings of the Sixth and Seventh Circuits. The Court of Appeals for the Sixth Circuit was presented with nearly identical facts to those in this case. *In re Montgomery*, 983 F.2d 1389 (6th Cir. 1993). *Montgomery* involved a suit by a trustee against Third National Bank ("TNB") to recover a preferential transfer under 11 U.S.C. § 547. TNB was one of several banks in which the debtor was operating a check-kiting scheme. The scheme resulted in TNB having "negative collected balances" in the debtor's checking account. These negative balances, however, were apparently covered by the debtor depositing kited checks to conceal the resulting overdraft. The bankruptcy court in that case held that the "[u]nauthorized loans created through the fraud of a check-kiting scheme constitute "debts" for bankruptcy purposes." *In re Montgomery*, 123 B.R. 801, 808 (Bankr. M.D. Tenn. 1991), aff'd, 136 B.R. 727 (M.D. Tenn. 1992), aff'd, 983 F.2d 1389 (6th Cir. 1993). The bankruptcy court continued:

> The debtors' check kiting was a misappropriation or conversion of TNB's money. *Walser v. International Union Bank* (In re Cohn), 21 F.2d 294, 296 (2d Cir. 1927). Check kiting realigned the ordinary debtor/creditor relationships at work in the cash management accounts by rendering Montgomery and Southland the Bank's debtors. The unauthorized loans generated by the debtors' kiting of checks gave rise to a "right to payment" in Third National Bank.

Id. at 808-809.

Like UMB, TNB watched the negative balances grow, began charging interest on those negative collected balances, and subsequently demanded that the liabilities be satisfied. The negative balances owing to TNB were eliminated when the debtor stopped kiting checks at TNB prior to the kite collapsing.

The Sixth Circuit and the two lower courts in *Montgomery* recognized that it was the debtor's negative collected balances that represented the amount of the antecedent debt that was repaid. *Montgomery*, 983 F.2d at 1390, 1391, 1392; see also *Montgomery*, 123 B.R. at 804, 805, 809, 810, 816; *Montgomery*, 136 B.R. at 729. The opinions of the bankruptcy court, the district court, and the Sixth Circuit all identified the nature of the debt resulting from the debtor's fraudulent check kiting and all held that the elimination of the negative collected balance was a repayment of an unsecured debt and a voidable preference.

In its decision, the Court of Appeals in this case expressly "disagree[d] with [the] broad language in the opinions" in *Montgomery*. App., *infra*, 8-9a n.4. While the Court of Appeals opinion goes on to attempt to reconcile its views with those of the Sixth Circuit, the conflict is deeper than the Eighth Circuit would admit.[9]

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[9] The Court of Appeals here stated that it agreed with the *result* in *Montgomery* because that case involved a line of credit, which was used to cover checking overdrafts, and "[d]raws on that line of credit, like any other, created depositor debt for preference purposes." App., *infra*, 8a-9a. However, this attempted reconciliation with *Montgomery* overlooks the fact that the line of credit in that case was only $500,000, but the amount actually found to be recoverable from TNB in *Montgomery* as a result of the check kite was approximately $2 million. See 983 F.2d at 1392 n.3. Thus, the real measure of the debt for preference purposes was the negative collected balances, not the line of credit.

The Court of Appeals' holding in this case also conflicts with *In re Smith*, 966 F.2d 1527 (7th Cir. 1992), cert. dismissed, 506 U.S. 1030 (1992). *Smith* involved the question whether payments made on kited checks constituted a transfer of the debtor's property for preference purposes. The Seventh Circuit stated:

> In effect, the Debtor here obtained a loan from the Bank (through the check-kiting scheme) and used the loan proceeds to pay his debt to Baker & Schultz. We might say that the loan was unauthorized or obtained by fraud, but it was nevertheless in economic reality a loan.

966 F.2d at 1532.[10]

A writ of certiorari, therefore, should be granted to resolve the conflict among circuits over the application of § 547(b)(2)'s use of the term "debt."

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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FEBRUARY 24, 1997

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[10] Senior UMB officers described UMB's creditor-debtor relationship with Kroh in exactly the same way. See C.A.App. 509-10, 516, 519.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 95-3872

BERRY F. LAWS, III, Trustee, *Plaintiff-Appellant*,

v.

UNITED MISSOURI BANK OF KANSAS CITY, N.A., *Defendant-Appellee.*

The Missouri Bankers Association, *Amicus Curiae.*

Submitted May 15, 1996

Decided Oct. 21, 1996
Rehearing and Suggestion for Rehearing En Banc Denied Nov. 26, 1996

Before FAGG, WOLLMAN, and LOKEN, Circuit Judges.

LOKEN, Circuit Judge.

On October 20, 1986, Kroh Brothers Development Company ("Kroh") wire transferred $4 million into its checking account at United Missouri Bank of Kansas City ("UMB"). In February 1987, Kroh filed for Chapter 11 bankruptcy protection. The trustee then commenced this proceeding to recover the $4 million from UMB as an avoidable preference under the Bankruptcy Code. The district court[1] held that provisional credits UMB extended before collecting Kroh's deposits were "antecedent debts" for purposes of 11 U.S.C. § 547(b)(2). However, the court concluded there was no preference, and granted summary judgment to UMB, because the $4 million transfer did not

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[1] The HONORABLE HOWARD F. SACHS, United States District Judge for the Western District of Missouri.

improve UMB's position as a fully secured creditor under Mo.Rev.Stat. § 400.4-210(a)(3). *Laws v. United Mo. Bank of Kansas City*, 188 B.R. 263 (W.D.Mo.1995).

The trustee appeals, arguing that the transfer enabled UMB to avoid losses from Kroh's on-going check-kiting scheme. While defending the district court's grant of summary judgment, UMB and The Missouri Bankers Association as amicus curiae argue that the court erred in treating provisional credits for uncollected deposits as antecedent debts. Though we disagree with the district court's interpretation of antecedent debt, we agree with its analysis of the Kroh/UMB relationship and therefore affirm.

Before filing for Chapter 11 protection, Kroh was a large real estate developer that regularly took advantage of the fact that UMB and other banks allowed Kroh to write checks on uncollected deposits. To illustrate how the bank collection process provided this opportunity, assume Kroh deposited a check drawn on another Kansas City bank into its UMB account on Monday afternoon. UMB provisionally credited Kroh's account for the amount deposited at the close of business that day, thereby permitting Kroh to write checks against the deposit. On Tuesday morning, UMB sent the check to the Kansas City Clearing House ("Clearing House") for collection. At Tuesday noon, the Clearing House presented the check to the drawee bank and provisionally credited UMB's Clearing House account. The drawee bank then had until midnight Wednesday to pay or dishonor the check. If the drawee bank paid, the provisional credits from the Clearing House to UMB and from UMB to Kroh's account became final. If the drawee bank dishonored the check before Wednesday, the Clearing House and UMB would reverse their provisional credits. *See generally* Mo.Rev.Stat. §§ 400.4-202, 400.4-215.

The ability to write checks against provisional credits gives the shrewd bank customer free use of someone else's money. Viewed charitably, this is called aggressive cash

management. It also gives the dishonest customer a chance to write checks against non-existent deposits. When done systematically and fraudulently, prosecutors call this criminal check kiting. *See Williams v. United States*, 458 U.S. 279 (1982). By whatever name it is called, when done with large amounts of money, it exposes banks to large losses, and they do not willingly tolerate the practice.

Because of these bank collection delays, at the time in question UMB calculated two balances for its customer accounts, the "ledger balance" and the "collected funds balance." The ledger balance was the sum of all collected and uncollected deposits, less debits to the account such as checks presented for payment. The collected funds balance consisted of collected funds less debits to the account. UMB's practice was to pay checks drawn on a customer's provisional credits. In other words, UMB refused to pay only if paying would result in a negative *ledger* balance. When paying resulted in a negative collected funds balance, UMB in effect advanced money it would owe the customer when (and if) all uncollected deposits were collected.[2]

In 1986, as Kroh approached insolvency, it increasingly used UMB's provisional credits. Kroh's average negative collected funds balance at UMB grew from $287,000 in March 1986 to $2,600,000 in September 1986. UMB was aware of this development and in June, with Kroh's consent,

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[2] Most banks give customers same-day or next-day availability for both local and nonlocal checks, and banks ultimately collect the vast majority of checks for which such provisional credit is granted. *See* Clark and Clark, *The Law of Bank Deposits, Collections & Credit Cards* ¶ 9.08 (1996 cum. supp. 2); Cooper, *Checks Held Hostage—The Funds Availability Controversy*, 102 Banking L.J. 532, 537 (1985). The U.C.C. encourages this practice. *See* Mo.Rev.Stat. § 400.4-210, Official U.C.C. Comment 1. The Expedited Funds Availability Act of 1987 mandates expedited availability in many situations. *See* 12 U.S.C. §§ 4001-4010.

began charging Kroh interest on its month-end negative collected funds balance. Though Kroh avoided an overdraft position by maintaining a positive ledger balance, its negative collected funds balance continued to grow. On October 17, UMB concluded it was unacceptably at risk and advised Kroh that it would no longer pay on Kroh's uncollected deposits. On October 20, Kroh borrowed from another bank and wire transferred $4 million of the loan proceeds to its account at UMB, virtually eliminating Kroh's negative collected funds balance. This satisfied UMB's immediate concern, but it only succeeded in keeping Kroh out of bankruptcy until February 1987.

To recover this pre-petition transfer as preferential, the trustee must prove that Kroh's property was transferred to or for the benefit of UMB; that the transfer was made when Kroh was insolvent for the purpose of satisfying an antecedent debt to UMB; that UMB was an insider (because the transfer was made more than ninety days before Kroh's bankruptcy filing); and that the transfer enabled UMB to receive more than it would have received in a Chapter 7 liquidating bankruptcy. *See* 11 U.S.C. § 547(b)(1)-(5). In granting UMB summary judgment, the district court considered only whether the $4 million transfer satisfied an antecedent debt, and whether that transfer enabled UMB to improve its position as a creditor of Kroh. The court noted "strong evidence of a check-kiting scheme in October." 188 B.R. at 271 n. 16. Therefore, in reviewing the facts in the light most favorable to the trustee, we will assume UMB knew that Kroh was likely kiting checks.

On appeal, the trustee argues that Kroh's negative collected funds balance at UMB on October 20, 1986, was an "antecedent debt" to UMB, and that elimination of that balance improved UMB's position as a creditor. Those are the only issues before us, and the trustee must prevail on both to avoid summary judgment for UMB. In other words, we will affirm if we conclude either that there was no antecedent

debt, contrary to the district court's conclusion, or that the transfer did not improve UMB's position, as the district court held. We of course review the district court's grant of summary judgment *de novo*. *See, e.g., Thomason v. SCAN Volunteer Serv., Inc.*, 85 F.3d 1365, 1370 (8th Cir.1996).

I. The Antecedent Debt Issue.

The Code defines "debt" as a "liability on a claim." 11 U.S.C. § 101(12).[3] When a debt was incurred is often important for preference purposes. In this circuit, "a debt is incurred on the date upon which the debtor first becomes legally bound to pay." *In re Iowa Premium Serv. Co.*, 695 F.2d 1109, 1111 (8th Cir.1982) (en banc); *accord In re Gold Coast Seed Co.*, 751 F.2d 1118, 1119 (9th Cir.1985); *see generally* 4 Collier on Bankruptcy, ¶ 547.10 n. 3 (15th ed. 1996).

If a customer deposits a check, immediately withdraws the entire amount in cash, and the check is later dishonored, common sense and the Uniform Commercial Code tell us that the bank has a claim against the customer for the dishonored amount. *See* Mo.Rev.Stat. § 400.4-214(a). On the other

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[3] "Claim" is defined as "a right to payment, whether ... liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5). Congress defined "claim" broadly so that "[a]ll claims against the debtor, whether or not contingent or unliquidated, will be dealt with in the bankruptcy case." H.R.Rep. No. 95-595, 95th Cong., 2d Sess. 180, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6141. Though the bankruptcy concepts of "claim" and "debt" are generally coextensive, the debt issue in this case does not affect the bankruptcy court's authority to deal with all claims against Kroh's estate. Indeed, to the extent that a check kiter, in moving money rapidly between a group of unsuspecting banks, generates negative collected funds balances which, in the aggregate, exceed the actual "kite debt," the rule urged by the trustee would seem to create redundant bankruptcy claims.

hand, most bank deposits do not create claims *against* the bank customer. Quite the opposite. "A person with an account at a bank enjoys a claim *against the bank* for funds in an amount equal to the account balance." *Barnhill v. Johnson*, 503 U.S. 393, 398, 112 S.Ct. 1386, 1389, 118 L.Ed.2d 39 (1992) (emphasis added). So at some point in the unsuccessful collection process, a "role reversal" occurs, with the putative customer-creditor becoming a customer-debtor of the bank. There are three times when this type of debt might logically be "incurred" for preference purposes--when the bank provisionally credits the customer's account for a deposited check, when the customer uses that provisional credit by drawing down the account, or when the deposited check is in fact dishonored. The first two would expose banks to preference liability every time they advance funds against uncollected deposits. The third would limit preference exposure to dishonor (ledger overdraft) situations.

Are Provisional Credits Depositor Debt? The district court ruled that a depositor incurs a debt when the bank provisionally credits the account for uncollected deposits, "regardless of whether the depositor makes use of this credit." 188 B.R. at 268. Other courts have consistently refused to hold that the mere extension of provisional credit creates a bankruptcy debt. *See Matter of Smith*, 966 F.2d 1527, 1535 & n.12 (7th Cir.), *cert. dism'd sub nom. Baker & Schultz, Inc. v. Boyer*, 506 U.S. 1030, 113 S.Ct. 683, 121 L.Ed.2d 604 (1992); *In re Frigitemp Corp.*, 34 B.R. 1000, 1015-16 (S.D.N.Y.1983); *In re Hudson Valley Quality Meats, Inc.*, 29 B.R. 67, 77 (Bankr.N.D.N.Y.1982) (bank that granted provisional credit to a check kiter received no preference when deposited funds were collected).

We find these decisions persuasive. A provisional credit, like a line of credit, is no more than the opportunity to obtain funds. Like a credit card, a line of credit does not create debt until the customer uses the credit to borrow funds or obtain goods or services. *See In re Hersman*, 20 B.R. 569,

572 (Bankr.N.D.Ohio 1982). Therefore, even if actual advances against uncollected deposits are loans, the depositor does not incur this debt when the bank first provisionally credits the amount of an uncollected deposit to the depositor's account.

Are Routine Advances Against Uncollected Deposits Depositor Debt? In this case UMB did not simply post provisional credits to Kroh's account. Kroh drew against its uncollected deposits, creating large negative collected funds balances. Abandoning the district court's analysis, the trustee argues that a depositor first incurs a debt when it draws against uncollected deposits. This is a more plausible position. Certainly the depositor receives tangible value when permitted to draw against uncollected deposits. At this point, for preference purposes, "the provisional credit [has] ripened into an interest in property of the Debtor." *Matter of Smith*, 966 F.2d at 1535.

But to say that advances drawn by the depositor are his property does not necessarily mean that the depositor thereby incurs a debt. The bank is the depositor's agent during the collection process. *See* Mo.Rev.Stat. § 4-215, Comment 9. The bank routinely makes uncollected funds available to the depositor, not as a loan, but in recognition of the bank's anticipated debt to the depositor. Because the vast majority of deposits are collected, banks do not see the decision to make advances on uncollected deposits as a credit decision. It is a service decision, driven by laws such as the Expedited Funds Availability Act, and by the financial demands of bank customers. True, a debt will arise if deposited checks are dishonored. But until dishonor, a bank that advances funds in the expectation that deposits will routinely be collected acts as a conduit for the depositor's financial transactions, not as a creditor. *See In re Chase & Sanborn Corp.*, 848 F.2d 1196, 1201 (11th Cir.1988).

The test for when a debt is incurred is whether the debtor is legally obligated to pay. Because the bank collection

process is rapid, there are no prior cases determining whether a bank has a legal right to recover advances on uncollected deposits *before those deposits are dishonored*. But it is worth noting that banks do not behave as though they have a right to repayment before dishonor. In this case, for example, when UMB concluded in June 1986 that Kroh's negative collected funds balance was too high, it did not demand repayment. Instead, UMB threatened to stop advancing credit on *future* uncollected deposits unless Kroh agreed to pay interest on the resulting negative balances, and UMB did not charge such interest until Kroh agreed to that change in their relationship.

We further note that federal bank regulators do not consider routine advances on uncollected deposits to be "debts" to a bank. The Office of the Comptroller of Currency in calculating whether a bank has exceeded its lending limit defines "extensions of credit" to exclude "amounts paid against uncollected funds in the normal process of collection." 12 C.F.R. §§ 32.2(j)(2)(v). Apparently, the Federal Reserve Board has long taken a similar view. *See* Clark and Clark ¶ 9.08, at S9-6 & n. 48 (1996 Cum.Supp. No. 2).

Although the issue is not free from doubt, we conclude that routine advances against uncollected deposits do not create a "debt" to the bank.[4] A contrary rule would be inconsistent with the parties' expectations and their view of

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[4] The trustee relies on *In re Montgomery*, 123 B.R. 801 (Bankr.M.D.Tenn.1991), *aff'd*, 136 B.R. 727 (M.D.Tenn.1992), aff'd, 983 F.2d 1389 (6th Cir.1993). Although we disagree with broad language in the opinions in that case, we agree with the result. *Montgomery* involved a bank that granted a check-kiting depositor a $500,000 line of credit to cover ledger overdrafts in a checking account. *See* 123 B.R. at 811. Draws on that line of credit, like any other, created depositor debt for preference purposes.

the banking relationship. A contrary rule would pin banks between the strong federal policy in favor of expedited funds availability and a Bankruptcy Code that treats advances as loans and their reduction as preferences. Such a rule might cause banks to terminate a service that is invaluable in today's economy. See *In re Frigitemp*, 34 B.R. at 1020. At a minimum, it would immensely complicate many bankruptcy proceedings.[5]

What If the Advances Were Not Routine? Our analysis thus far has dealt with advances that a bank routinely makes available against a depositor's uncollected deposits. But this is not the usual case. Here, as Kroh's negative collected funds balance grew rapidly in mid-1986, UMB viewed the situation with alarm. Internal bank documents described Kroh's negative balance as "an interest free loan," and a bank officer testified, "we were lending money and the loan was not approved." Concluding that the situation was unacceptable, UMB gave Kroh the option of eliminating the negative balances or paying interest on them. When Kroh agreed to pay interest, its negative collected funds balance began to reflect a banking relationship having many indicia of a loan. Had Kroh and UMB explicitly agreed to convert future negative collected funds balances into loans, Kroh would have been legally bound to pay such debts as incurred.

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[5] The trustee argues that, to determine the debt owing to banks before a check kite "collapses," one must "(i) examine and reconcile the bank statements, deposits, and paid checks from all the accounts in the kite with one another; (ii) remove kite checks and deposits from the system by all banks with negative collected balances by returning all items that were still subject to return under the rules of the Clearing House; (iii) the resultant balance is the actual debt owing to the bank based on the actual flow of funds." Brief of Appellant 28. We are loathe to adopt a rule that would require litigation of these issues every time a debtor in bankruptcy is alleged to have been "kiting checks."

Whether such an agreement may here be implied is a disputed issue of material fact. Thus, while we arrive at this conclusion by a different analysis, we agree with the district court that UMB was not entitled to summary judgment on the issue whether the $4 million transfer satisfied Kroh's antecedent debt to UMB.

II. Whether UMB Improved Its Position.

The district court granted summary judgment on the ground that Kroh's antecedent debt--its negative collected funds balance--was fully secured and therefore the $4 million transfer did not improve UMB's position. We agree. When a check is deposited for collection, Missouri's Uniform Commercial Code grants the depository bank a security interest in the check and its proceeds "to the extent to which credit given for the [check] has been withdrawn or applied." Mo.Rev.Stat. § 400.4-210(a)(1). Thus, at all times, UMB had a security interest in the deposited checks and provisional Clearing House credits underlying Kroh's negative collected funds balance. Collection and final settlement realized UMB's security interest on those checks. § 400.4- 210(c). The trustee concedes that UMB ultimately collected the checks that comprised Kroh's negative collected funds balance on October 20, 1996. Thus, the district court's decision that UMB did not improve its fully secured position appears to state the obvious. *Cf. In re Two S. Corp.*, 875 F.2d 240 (9th Cir.1989) (amount received from the disposition of collateral in a commercially reasonable manner determines its value).

The trustee urges a different result in this case because Kroh was allegedly kiting checks and kited checks are worthless. But as the district court noted, the deposited checks in an on-going check kite are not worthless, though some may be dishonored if the kite collapses. 188 B.R. at 270, citing Mo.Rev.Stat. § 400.4-210, comment 3. The trustee's theory finds no support in the language of § 547(b) of the Bankruptcy Code and Article 4 of the Missouri Uniform Commercial Code. In these circumstances, we

agree with the district court that UMB was a fully secured creditor. As the court said in *In re Frigitemp*, 34 B.R. at 1015-16 (citation omitted):

> Because the bank's security interest in the check and its proceeds was released when the provisional credit was repaid ... the estate was not depleted and no preferential transfer occurred. Whether a provisional credit is construed as a loan secured by the check, or simply as too "provisional" to be treated as debt for bankruptcy purposes, it cannot properly serve as the basis for preference liability.

The judgment of the district court is affirmed.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 95-3872WMKC

BERRY F. LAWS, etc.,

Appellant,

vs.

UNITED MISSOURI BANK, etc.,

Appellee.

Order Denying Petition for Rehearing and Suggestion for Rehearing En Banc

November 26, 1996

The suggestion for rehearing en banc is denied. The petition for rehearing by the panel is also denied.

Order Entered at the Direction of the Court:

/s/ Michael E. Gens

Clerk, U.S. Court of Appeals, Eighth Circuit

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MISSOURI,
WESTERN DIVISION

No. 91-0283-CV-W-6.

BERRY F. LAWS, III, *Plaintiff*,

v.

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
Defendant.
Sept. 19, 1995

Order Denying Reconsideration
Oct. 13, 1995

MEMORANDUM AND ORDER

SACHS, Senior District Judge.

This action arises out of events that occurred some months prior to the voluntary petition filed on February 13, 1987, by Kroh Brothers Development Company ("KBDC"), under Chapter 11 of the Bankruptcy Code. Plaintiff's predecessors, KBDC and the Kroh Operating Limited Partnership ("KOLP"), filed the above-captioned action in order to recover a setoff and preferential transfers allegedly received by defendant United Missouri Bank of Kansas City, N.A. ("UMB"). Count 1 of plaintiff's second amended complaint seeks avoidance of an alleged setoff under 11 U.S.C. § 553(b). In Count 2, plaintiff alleges a preferential transfer under 11 U.S.C. § 547.[1] In Count 3, plaintiff

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[1] Plaintiff alleges in Count 2 that on November 20, 1986, KBDC was indebted to UMB in the amount of $645,013.93. Plaintiff further alleges that KBDC subsequently made three transfers on account of the antecedent debt. This order refers to those transactions as the "November transactions."

alleges that KBDC was operating a check-kiting scheme and seeks to recover an alleged preferential transfer to insider UMB under 11 U.S.C. § 547.[2] After extensive though fitful discovery by the various parties, this matter is currently before the court on cross-motions for summary judgment.

Standard for Summary Judgment

Summary judgment is appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed.R.Civ.P. 56(c). Facts must be viewed in the light most favorable to the nonmoving party, who must be given the benefit of all reasonable inferences that may be made from the facts disclosed in the record. *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 153-61, 90 S.Ct. 1598, 1606-10, 26 L.Ed.2d 142 (1970); *Raschick v. Prudent Supply, Inc.*, 830 F.2d 1497, 1499 (8th Cir.1987), *cert. denied*, 485 U.S. 935, 108 S.Ct. 1111, 99 L.Ed.2d 272 (1988).

If a party is unable to make a sufficient showing as to some essential element of its case upon which it will bear the ultimate burden of proof at trial, all other facts are necessarily immaterial. *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23, 106 S.Ct. 2548, 2552-53, 91 L.Ed.2d 265 (1986). A party seeking summary judgment bears the initial burden of demonstrating to the court that an essential element

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[2] Plaintiff alleges in Count 3 that on October 19, 1986, KBDC had a negative funds balance in its UMB account in excess of $4,000,000. Plaintiff further alleges that this debt was repaid by a preferential transfer effected by either (1) a $7,000,000 loan from Commerce Bank of Kansas City, the proceeds of which were deposited into a KBDC checking account at Commerce, or (2) a $4,000,000 wire transfer from Commerce to UMB. These transactions will be referred to as the "October transactions."

of the nonmoving party's case is lacking. *Id.* The burden then shifts to the nonmoving party to come forward with sufficient evidence to demonstrate that there is a factual controversy as to that element, or to explain why such evidence is currently not available. *Id.*; Fed.R.Civ.P. 56(e). If the nonmoving party fails to so respond, summary judgment, if appropriate, shall be entered against such party. Fed.R.Civ.P.56(e). The nonmoving party must come forward with sufficient evidence to allow a reasonable jury to find in its favor. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 251, 106 S.Ct. 2505, 2511-12, 91 L.Ed.2d 202 (1986).

Count 1

Count 1 of the second amended complaint alleges an improvement in position by setoff, under 11 U.S.C. § 553(b), within 90 days prior to the filing of the bankruptcy petition. Plaintiff acknowledges that this court's prior ruling on the subject of UMB's insider status moves the preference period to one year preceding the bankruptcy filing. As a result, plaintiff concedes that he cannot recover on the 90-day improvement in position claim in Count 1. *See* Suggestions in Support of Plaintiff's Motion for Partial Summary Judgment and in Opposition to Defendant's Motion for Summary Judgment at 57-58. Therefore, defendant is entitled to summary judgment on Count 1 of the complaint.

Count 3

Plaintiff seeks to recover $4,000,000 from defendant under Count 3 of his complaint. Plaintiff's theory is that KBDC's negative funds balance in its UMB checking account on October 19, 1986, was a "debt" owed to UMB, and that KBDC's wire transfer of $4,000,000 on October 20 extinguished that debt and was therefore an avoidable preferential transfer within the meaning of 11 U.S.C. § 547(b). At no time during the period in question was there a conventional bank loan from UMB to KBDC.

Both parties recognize that in order to prevail on his preference claim, the trustee must establish the following elements: (1) there was a transfer of an interest of the debtor in property; (2) the transfer was to or for the benefit of a creditor; (3) the transfer was for or on account of an antecedent debt; (4) the debtor was insolvent at the time of the transfer; (5) the transfer was made between 90 days and one year before the date of the debtor's bankruptcy filing; and (6) the transfer enabled the creditor to receive more than it would have received in a Chapter 7 liquidation. See 11 U.S.C. § 547(b). The parties have focused their extensive briefing primarily on factors (1) through (3). Issues relating to factor (4) are still in discovery, but on "hold" at plaintiff's request. Oral argument has been heard on an unsigned draft of an opinion on the parties' cross motions for summary judgment.[3]

The $4,000,000 wire transfer that is the subject of Count 3 was made at 3:23 p.m. on Monday, October 20, 1986. The existence and extent of any antecedent debt owed by KBDC to UMB must accordingly be determined as of that time. Because the activity in the KBDC account on the days leading up to October 20 is quite crucial, attached to this order is an exhibit, which was submitted by the plaintiff at oral argument, that shows the account balances of KBDC for October 15, 16, 17, and 20, 1986. The columns showing checks returnable (but not returned) under the "midnight deadline" rule are omitted.

The exhibit contains UMB's ledger balance for the KBDC account and the balance under clearing house flow of

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[3] With respect to Count 3, the unsigned draft essentially concluded that defendant was entitled to summary judgment because no antecedent debt existed at the time of the $4,000,000 wire transfer. On further consideration the analysis is defective in light of the artificially broadened statutory language treating unmatured contingent obligations as debts.

funds rules. For purposes relevant here, clearing house rules govern the timing of provisional credit and settlement of deposits. When the bank received checks from a depositor, it transferred the checks to the clearing house and received provisional credit for the face amount of the checks. This provisional credit was available at noon on the business day that the deposits were submitted to the clearing house. Exhibit 1 to (1) Plaintiff's Statement of Uncontroverted Facts and Plaintiff's Response to Defendant's Statement of Allegedly Uncontroverted Facts and (2) Plaintiff's Suggestions in Support of His Motion for Partial Summary Judgment and in Opposition to Defendant's Motion for Summary Judgment, Affidavit of Donald E. Thomas, ¶ 6(a). This provisional credit was then extended to the depositor. *Id.* Final settlement occurred at midnight on the second business day following the grant of provisional credit. *Id.* at ¶ 6(b). UMB's practice was to submit deposits to the clearing house on the day following receipt, *Id.* at ¶ 7, and thus it received provisional credit at noon on the day following the receipt of the deposits, which was then extended to its depositor.

At oral argument and in its briefs, UMB contends that whether an antecedent debt existed should be determined by the ledger balance for the KBDC account. Because the ledger account balance was positive during the relevant time frame, UMB claims that the wire transfer could not have been on account of an antecedent debt. Until settlement of deposited checks is final,[4] however, the depositor is treated as the owner of the deposited checks, even if credit is extended for the checks and a withdrawal against that credit occurs. Uniform Commercial Code ("U.C.C.") § 4-201.[5] It is

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[4] *I.e.*, midnight of the second business day following the grant of provisional credit.

[5] Section references will be to the U.C.C. unless otherwise

perhaps accurate to say that, prior to final settlement, the bank has a contingent right to ownership of the deposited items (the contingency being the clearance of the checks) and the depositor has ownership of the checks subject to a condition subsequent. The reconstructed account using clearing house rules reflects this state of ownership. *In re Montgomery*, 123 B.R. 801, 810 (Bankr.M.D.Tenn.1991), *aff'd*, 136 B.R. 727 (M.D.Tenn.1992), *aff'd*, 983 F.2d 1389 (6th Cir.1993). Clearing house rules, moreover, have the same effect as an agreement between the parties unless specified otherwise. § 4-103(b). The existence of an antecedent debt will accordingly be determined by KBDC's account under clearing house rules.

KBDC obtained the funds for the $4,000,000 wire transfer from a $7,000,000 unsecured loan from Commerce Bank. UMB, relying on the earmarking defense to a trustee's claim of preferential transfer, asserts that the wire transfer merely changed the identity of the creditor to whom the debt was owed. The earmarking doctrine was discussed at length in *In re Bohlen Enterprises, Ltd.*, 859 F.2d 561 (8th Cir.1988). The following requirements must be met for the earmarking doctrine to apply: (1) an agreement between the new lender and the old debtor that the loan proceeds will be used to pay a specific antecedent debt; (2) performance of that agreement; and (3) when viewed as a whole, the transaction does not diminish the property of the estate. *Id.* at 566. UMB concedes that the purpose of the Commerce loan was "to inject current funds into the account at Commerce." Defendant UMB's Suggestions in Opposition to Plaintiff's Motion for Partial Summary Judgment, at 26. UMB does not allege that the disclosed purpose of the Commerce loan was to repay an antecedent debt *to UMB*,

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noted.

which renders the earmarking defense unavailable. *Matter of Smith*, 966 F.2d 1527, 1533 (7th Cir.1992).[6]

The Bankruptcy Code treats "debt" as the converse of a "claim." *In re Morton*, 43 B.R. 215, 219-20 (Bankr.E.D.N.Y.1984). Consequently, for purposes of the Bankruptcy Code, if UMB had a claim against KBDC, KBDC owed a debt to UMB. "Claim" is defined as a

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured[.]

11 U.S.C. § 101(5). This definition is to be given the broadest construction possible. *Johnson v. Home State Bank*, 501 U.S. 78, 83, 111 S.Ct. 2150, 2153-54, 115 L.Ed.2d 66 (1991). Although "claim" is defined in the Bankruptcy Code, whether a right to payment exists is determined by state law. *In re Mandalay Shores Co-op. Housing Ass'n*, 54 B.R. 632, 635 (Bankr.M.D.Fla.1984). Applicable state law in this case

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[6] As stated in the initial draft, this ruling does not necessarily represent my view of sound public policy or "what's fair," as between the bank and the general creditors. As an involuntary creditor the bank has a greater claim to sympathy, perhaps, than would a voluntary lender forced to disgorge a late repayment, for equality of treatment with other creditors. The Commerce loan, moreover, suggests that the general creditors did not suffer a diminution of the debtor's estate by reason of the flurry of activity on the days in question--but rather a substitution of creditors that does not quite qualify for application of the earmarking rule.

is Article 4 of the U.C.C., codified at Mo.Rev.Stat. §§ 400.4-101, 400.4-504.

Plaintiff contends that the debt KBDC owed to UMB at the time of the wire transfer is represented by the account balance at the close of business on Friday, October 17. This balance is negative $4,215,278.20. Since this "debt" exceeded the amount of the wire transfer on October 20, the entire amount of the wire transfer was on account of an antecedent debt, according to plaintiff.

Plaintiff's theory does have some appeal, but it appears to the court that this approach does not present a realistic picture of the amount of the depositor's debt, nor does it properly classify the debt. As noted *supra*, until final settlement, the depositor is treated as the owner of the deposited items. Because credit is extended by the bank prior to final settlement, however, the bank has a claim against the depositor (and the depositor has a debt to the bank) in the amount of the provisional credit extended, regardless of whether the depositor makes use of this credit. *In re Montgomery*, 123 B.R. at 809; *cf. In re Frigitemp Corp.*, 34 B.R. 1000, 1016 (S.D.N.Y.1983) (declining to treat provisional credit as creating a debtor-creditor relationship under normal circumstances, but suggesting that the result could differ in nonroutine situations), *aff'd*, 753 F.2d 230 (2d Cir.1985). The depositor's use of this credit by, *e.g.*, writing checks to third parties, does not necessarily alter the depositor's obligation to the bank, even if those checks are paid by the bank, although it does create a liability to the third parties. § 3-414 (drawer liability); *In re Hudson Valley Quality Meats, Inc.*, 29 B.R. 67, 75 (Bankr.N.D.N.Y.1982). The use of provisional credit creates a liability to the bank only if the bank pays checks that result in the depositor's account being overdrawn.[7] *See In re Hudson Valley Quality*

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[7] The bank is entitled to charge a depositor's account even if the

Meats, Inc., 29 B.R. at 74-75 (application of provisional credit can increase depositor's liability as well as extend it to third parties). The bank has a claim against the depositor for the amount of the overdraft, and the depositor has a corresponding debt. *See id.* The total amount of the debt, therefore, is the amount of provisional credit extended, plus the checks and other account debits paid by the bank that exceed this grant of provisional credit.

UMB, asserting a security interest in the deposited checks and their proceeds, contends that any antecedent debt that did exist was fully secured. Classification of the debt is covered by § 4-210(a), which states:

> A collecting bank has a security interest in an item and any accompanying documents or the proceeds of either:
>
> (1) in case of an item deposited in an account, to the extent to which credit given for the item has been withdrawn or applied;
>
> (2) in case of an item for which it has given credit available for withdrawal as of right, to the extent of the credit given whether or not the credit is drawn upon or there is a right of charge-back; or
>
> (3) if it makes an advance on or against the item.

No security agreement is necessary for the creation of this security interest, § 4-210(c)(1); attachment occurs automatically once the statutory prerequisites are met. § 203(2). This security interest is perfected without the necessity of filing, § 4-210(c)(2), and it has priority over competing interests. § 4-210(c)(3). When UMB provisionally extended credit to KBDC, therefore, it took a security interest in the deposited checks. *See Frigitemp*, 34 B.R. at 1015. Whether the bank had a security interest is critical in this case because a transfer to a fully secured

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charge creates an overdraft. §4-401(a).

creditor is not a preference since there is no "preferential effect." *Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.)*, 990 F.2d 551, 554 (10th Cir.1993); *Henderson v. National Bank of Commerce (In re Al-Ben, Inc.)*, 156 B.R. 72, 75 (Bankr.N.D.Ala.1991). If UMB had a secured claim against KBDC equal to or greater than $4,000,000 at the time of the transfer, the transfer cannot be reclaimed as a preference.[8]

Plaintiff seeks to sidestep UMB's assertion of a security interest by contending that, since the deposited checks were part of a kiting scheme, they lacked value and, accordingly, any security interest held by UMB was also valueless. UMB's status as a secured creditor in a liquidation proceeding would be governed by 11 U.S.C. § 506. A lien is valid under that section except to the extent that it secures a claim that is not an allowed secured claim. 11 U.S.C. § 506(d). For purposes relevant to this case, a claim is an allowed secured claim "to the extent of the value *of such creditor's interest* in the estate's interest in [the secured] property." 11 U.S.C. § 506(a) (emphasis added). This claim is not affected by a decline in the value of the property subject to the claim subsequent to judicial valuation, *Dewsnup v. Timm*, 502 U.S. 410, 417, 112 S.Ct. 773, 778, 116 L.Ed.2d 903 (1992), and the creditor is entitled to the benefit of any appreciation occurring prior to foreclosure. *Id.* In this Circuit, the creditor's interest is "valued in light of the purpose of the valuation and the proposed disposition or use of the

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[8] Any thought that UMB was enjoying a double payment, consummated by the subsequent clearance of the batches of checks that were in the process of collection, is countered when it is remembered that this simply built up KBDC's account and did not become UMB's property. Moreover, even if a suspicion of transfers in fraud of creditors might unsoundly persist, plaintiff's case is not based on such an assertion.

collateral." *In re Trimble*, 50 F.3d 530, 531 (8th Cir.1995).[9]

Plaintiff has cited many decisions in support of his assertion that kited checks are "worthless." *United States v. McKinney*, 822 F.2d 946 (10th Cir.1987); *United States v. Taylor*, 789 F.2d 618 (8th Cir.1986); *United States v. Sher*, 661 F.2d 34 (3d Cir.1981); *Suhl v. United States*, 390 F.2d 547 (9th Cir.1968); *Falconi v. FDIC*, 257 F.2d 287 (3d Cir.1958); *Stevens v. United States*, 227 F.2d 5 (8th Cir.1955). However, most of the language cited is derogatory commentary about perpetrators of Ponzi schemes in criminal prosecutions of the depositor; none arose under the Bankruptcy Code or dealt with the security interest of a victim in a kiting operation.[10] *See United States v.*

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[9] An alternate approach measures the creditor's interest by the wholesale value of the collateral. *In re Trimble*, 50 F.3d at 531 (citing cases).

[10] Plaintiff is correct that courts have frequently referred to checks drawn on accounts with insufficient funds as "bad checks" or "worthless checks," even in circumstances where there have been promises to deposit sufficient funds to cover the checks. *See, e.g., United States v. Taylor*, 789 F.2d at 623. It may be more precise usage to call checks worthless when there is "no reasonable prospect of paying" them. *Stevens v. United States*, 227 F.2d at 6. Like "junk bonds," they may turn out to be valuable, in that they result in the payment of money. Terming insufficient funds checks as "worthless" is less exaggerated than the claim of some tax protestors that Federal Reserve notes are "worthless" because they are not payable in bullion. But when real money (legal tender) is likely to be paid as the result of a temporarily successful check kite, it is difficult to say realistically or in an economic sense that the checks are wholly worthless.

Plaintiff offers no authority showing that a bank that has *not* been trapped at the end of a kiting scheme is nevertheless entitled

McKinney, 822 F.2d at 948 (prosecution for misappropriation of funds by check kiting); *United States v. Taylor*, 789 F.2d at 619 (mail fraud prosecution for role in a check-kiting scheme); *United States v. Sher*, 661 F.2d at 34 (prosecution for overvaluing securities in connection with a check-kiting scheme); *Suhl v. United States*, 390 F.2d at 548 (prosecution for mail fraud and other charges related to a check-kiting scheme); *Falconi v. FDIC*, 257 F.2d at 288-89 (suit by depositor against FDIC to recover amount appropriated from his account because of alleged connection with a check-kiting scheme); *Stevens v. United States*, 227 F.2d at 6 (mail fraud prosecution of perpetrator of a check-kiting scheme).

The existence and valuation of a security interest was apparently not argued in any of the *Montgomery* cases nor was it addressed by the bankruptcy, district, or appellate court.[11] The *Smith* court did recognize the security interest of the collecting bank. *Matter of Smith*, 966 F.2d at 1530.

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to *full* damages in the face value of the checks received and deposited on an implicit misrepresentation that there are adequate funds with the drawee bank. That would be the acid test of whether the kited checks are "worthless." In other words, in a kiting situation, substantial damage exposure moves back and forth; it does not *fully* affect *all* of the banks *all* of the time.

[11] The bank claimed that a line of credit was backed by a security interest in real property, but the bankruptcy court found that the bank had offered no evidence to rebut the trustee's proof that the bank was undersecured and thus had received more on its line of credit than it would have received in a Chapter 7 proceeding. *In re Montgomery*, 123 B.R. at 817. The issues on appeal were whether the voidable transfer was adequately identified, whether there was a transfer to the bank of an interest of the debtor in property, whether there was a diminution in the value of the debtor's estate, and the propriety of the prejudgment interest award. *In re Montgomery*, 983 F.2d at 1392; *In re Montgomery*, 136 B.R. at 730.

The valuation issue was not before the court, however, since the preference claim was asserted against the payee, not the bank. It is notable that, even though the deposited check was dishonored and was referred to by the court as a "bad" check, the court did not treat the bank's security as worthless. Rather, the court appeared to accept the trustee's argument that the security interest attached to the depositor's ability to control disposition of the provisionally credited funds. *Id.* at 1530-31.[12] The value of this interest would thus be equal to the unrestricted provisionally credited funds, since the depositor could exercise control over this amount. Following that approach, UMB would have a secured claim of $7,993,479.64, the amount of unrestricted provisional credit extended to UMB at the time of the $4,000,000 wire transfer.

The security interest of the collecting bank was an alternate basis for the holding in *Frigitemp*. *In re Frigitemp*, 34 B.R. at 1015-16. No kiting was present in that case, however. It thus appears that, other than general valuation principles, no clear guidance exists for the situation at hand. Treating the bank's security interest in the checks as "worthless" is probably unjustified, though, particularly in light of comment 3 to § 4-210, which notes the importance of the security interest in cases of noncollection. If plaintiff's theory were followed, the security interest would have value only when the checks were collected, which would be of little use to the lender.

Plaintiff also asserts that no proceeds resulted from the kited checks. Section 4-210, in addition to giving a collecting bank a security interest in items presented for collection, gives the bank an interest in the proceeds of those items. "'Proceeds' includes whatever is received upon the sale, exchange, collection or other disposition of collateral or

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[12] The bank did not make an exchange of the deposited checks and thus no proceeds were involved. *See infra.*

proceeds." § 9-306(1). At the time UMB credited KBDC's ledger account, its security interest was in the deposited checks. *Matter of Stiennon*, 73 B.R. 905, 908 (Bankr.W.D.Wis.1987); *see also* Richard Sauer, "Special Problems of Banks With Bankruptcy Debtor Customers," 61 Am.Bankr.L.J. 95, 122-23. However, contrary to plaintiff's contention, when UMB received credit for the items from the clearing house, it received "proceeds" within the meaning of § 9-306. *Matter of Stiennon*, 73 B.R. at 908 (Bankr.W.D.Wis. 1987); *see also Realty Growth Investors v. Commercial and Industrial Bank of Memphis, Tennessee*, 370 So.2d 297, 302 (Ala.Civ.App.1979) (exchange with the clearing house of deposited checks for credits creates proceeds from the deposited checks). UMB then transferred those proceeds to KBDC's account in the form of provisional extensions of credit. Accordingly, at the time of the wire transfer, UMB's security interest was not in the checks, but in the proceeds--the credits received from the clearing house. I have not heard and cannot imagine a sound argument that the security interest in the credits does not have dollar-for-dollar value for present purposes simply because the credits were subject to revocation if the collections miscarried. The additional fact-finding that would be required to place a value on the checks is unnecessary.[13]

The $4,000,000 wire transfer occurred at 3:23 p.m. on October 20. By that time, UMB's security interest had transferred to the proceeds from the clearing house exchange,

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[13] A contrary ruling would probably create a jury issue as to the "street value" of kited checks--a bizarre but not unprecedented undertaking. Courts routinely hear evidence of the street value of illegal drugs, and occasionally hear about the discounted value of stolen goods, high quality counterfeit currency and the like. In the absence of expert testimony, a jury could "pick a number" after hearing evidence about the likelihood that checks will clear and other pertinent facts.

from which it had received full value for the face amount of the checks. The amount of UMB's secured claim was $7,993,479.64, computed as follows: proceeds of the $3,952,000 in checks that were transferred to the clearing house on October 17 (on which final settlement was not made until midnight on October 21), plus the proceeds of the $4,041,479.64 in checks that were transferred to the clearing house on October 20 (on which final settlement was not made until midnight on October 22). Any checks paid by UMB that exceeded the amount of provisional credit[14] would be added to this amount to determine the total amount of debt KBDC owed to UMB. The court need not make this computation, however, because the $4,000,000 transfer did not enable UMB to receive more than it would have in a Chapter 7 liquidation since the amount of its security interest in the proceeds of the checks in the process of collection greatly exceeded the amount of the transfer.

Therefore, to the extent plaintiff has alleged an antecedent debt of approximately $4,000,000 on October 19 and a preferential wire transfer of $4,000,000 on October

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[14] This portion of the debt would be treated as unsecured, in the absence of an agreement otherwise between the parties.

20,[15] plaintiff cannot prevail under § 547. Defendant is entitled to summary judgment on Count 3.[16]

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[15] The court will not discuss at length plaintiff's alternative contention that $7,000,000 worth of loan proceeds deposited into an account at Commerce Bank constituted the preferential transfer to UMB. The court is aware of no relevant law that would support plaintiff's theory that UMB was a beneficiary of that particular deposit. Moreover, plaintiff acknowledges that he only asserted the $7,000,000 transfer theory "in anticipation that UMB might contend that the $7,000,000 deposit into the KBDC Commerce account repaid the debt." Response to UMB's Summary Judgment Motion at 12. UMB has not made that anticipated contention; therefore, plaintiff appears to have effectively abandoned the $7,000,000 claim.

[16] Defendant's "conduit" theory of defense is debatable with respect to the October transactions. The strong evidence of a check-kiting scheme in October, in addition to the interest charges on KBDC's negative collected balance from June 1986 through October 1986, conceivably distinguish the October transactions from the "conduit" transactions in *O'Neal v. Southwest Mo. Bank (In re Broadview Lumber Co., Inc.)*, 168 B.R. 941, 963 (Bankr.W.D.Mo.1994). Judge Federman's analysis of 11 U.S.C. § 550 in *Broadview* is applicable insofar as it addresses the question of whether a bank is a "transferee." The trustee seeks to avoid a transfer under § 547 of the Code, and to recover money under 11 U.S.C. § 550. Receipt of money by a mere conduit would not permit the trustee to prevail under either section. The decision in *Broadview* clearly stands for the proposition that a trustee may not recover funds deposited with a conduit. *Broadview*, 168 B.R. at 963-64. Moreover, receipt of money by a conduit, rather than a transferee, would not qualify as a "transfer of an interest of the debtor * * * to or for the benefit of a creditor" under 11 U.S.C. § 547(b). For the reasons set forth above, however, it is not necessary to reach the question of whether UMB was merely a conduit with respect to the October transactions.

Count 2

In Count 2 of the complaint, plaintiff seeks to recover a total of $645,013.93. Plaintiff's theory is that KBDC had a negative collected balance in its UMB checking account on November 20, 1986, and that KBDC made transfers to the account on November 21, 23, and 24, 1986, which constituted preferential transfers on account of an antecedent debt. Unlike the large wire transfer discussed in Count 3, the "transfers" referred to in Count 2 were bank-to-bank payments on checks previously deposited for collection. The court concludes, however, that the defendant bank was not a beneficiary of funds (which simply replenished its depositor's account) and was in fact nothing more than a "conduit" or agent receiving funds, not a "transferee" of KBDC's funds.

As noted above, defendant's contention that it was a mere "conduit" for KBDC funds is not conclusively supported by the authorities, with respect to the October transactions. However, the November transactions can be distinguished from the October transactions in at least two important ways. First, plaintiff has not alleged a check-kiting scheme in Count 2. Although plaintiff hints at such a scheme in his briefs, none was alleged in the complaint. Thus, the applicability of *Montgomery* (the Sixth Circuit litigation) is questionable, at best.

Second, in a provisional credit situation when no fraud has been alleged, the conduit analysis of *In re Chase & Sanborn Corp.*, 848 F.2d 1196, 1200-01 (11th Cir.1988), and *Broadview*, 168 B.R. at 963, is highly relevant. In *Broadview*, Judge Federman found no evidence that Southwest Missouri Bank or Mercantile Bank exercised any dominion over funds deposited into the debtor's accounts. *Broadview*, 168 B.R. at 963. The banks did not have a current right to seize or disburse the money for their own benefit, and were therefore nothing more than intermediaries, or conduits, of the debtor's funds. *Id.* They were not "transferees" of those funds. *Id.* Similarly, this court finds

that UMB was not a transferee of KBDC funds in November, and that plaintiff therefore can neither avoid the alleged transfers nor recover the property allegedly transferred. *See Chase & Sanborn*, 848 F.2d at 1200. As in *Chase & Sanborn*, when UMB received funds from KBDC in November 1986, UMB merely deposited the funds into KBDC's checking account and KBDC used the funds to pay certain checks drawn on the account. *Id.* at 1201. Unlike the characterization sometimes made in kiting cases, the transactions at issue in Count 2 "did not create a real debt." *Id.*

The issue of "benefit" under 11 U.S.C. § 547(b)(1) is closely related to the issue of UMB's role as conduit. *See, e.g., Bonded Financial Services v. European Amer. Bank*, 838 F.2d 890, 893 (7th Cir.1988).[17] The court finds that UMB received no benefit from the alleged preferential transfers in November. A distinction between the October and November transactions is that UMB apparently charged no interest to the KBDC account in November. Suggestions in Support of Plaintiff's Motion for Summary Judgment and in Opposition to Defendant's Motion for Summary Judgment at 9. UMB arguably was more than a conduit in October, because it charged the KBDC account $4,269.76 in interest during that month. Moreover, UMB charged the KBDC account more than $40,000 in interest prior to October. Such evidence lends support to the trustee's claim that UMB perceived and intended "that the use of uncollected funds in the [account] rendered [KBDC] the Bank's debtor." *Montgomery*, 123 B.R.

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[17] The court, writing through Judge Easterbrook, held that European American Bank, acting as a financial intermediary, "received no benefit." *Id.* The Bank "held the check only for the purpose of fulfilling an instruction to make the funds available to someone else." *Id.*

at 811.[18] Such evidence also supports a claim that UMB derived some benefit from the October transactions. In November, however, the bank charged no interest to the account. The statutory presumption of agency status, referred to in *Bonded Financial Services*, 838 F.2d at 893, cannot be rebutted by the materials before the court [19].

Plaintiff has failed to prove "transfers" to UMB in November "for the benefit of" UMB, and therefore defendant is entitled to summary judgment on Count 2 of the complaint.

Accordingly, for the reasons set forth above, it is hereby

ORDERED that plaintiff's motion for partial summary judgment is DENIED. It is further

ORDERED that defendant's motion for summary judgment on all three counts of plaintiff's second amended complaint is GRANTED.

	Ledger Balance	Funds Flow Under Clearing House Rules
WEDNESDAY, OCTOBER 15, 1986		
Negative collected funds as of the opening of business		(3,409,472.07)
Provisional credit for KBDC deposit of 10/14/86		3,686,438.15
Opening ledger balance 10/15/86	276,966.08	276,966.08
Checks deposited by KBDC	3,956,359.89	
Checks presented for payment	(4,157,324.10)	(4,157,324.10)
Wire transfers out	(32,635.54)	(32,635.54)

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[18] The court's conclusion in *Montgomery* was supported by the bank's assessment of "analysis charges" against the negative collected balance. *Id.*

[19] As the Eight Circuit has noted, the presumption applies to all collecting banks, including a depositary bank. *Alta Vista State Bank v. Kobliska*, 897 F.2d 930, 933 (8th Cir.1990).

Closing balance 10/15/86	43,366.33	(3,912,993.56)
THURSDAY, OCTOBER 16, 1986		
Checks deposited by KBDC	3,952,000.00	
Provisional credit for KBDC deposit of 10/15/86		3,956,359.89
Checks presented for payment	(3,882,175.01)	(3,882,175.01)
Closing balance 10/16/86	113,191.32	(3,838,808.68)
FRIDAY, OCTOBER 17, 1986		
Checks deposited by KBDC	4,041,479.64	
Checks presented for payment		(4,316,454.52)
Provisional credit for KBDC deposit of 10/16/86		3,952,000.00
Wire transfers out	(12,000.00)	(12,000.00)
NSF charge	(15.00)	(15.00)
Closing balance 10/17/86	4,142,655.96	(4,215,278.20)
MONDAY, OCTOBER 20, 1986		
Checks deposited by KBDC	1,105,000.00	
Checks presented for payment	(9,232,133.03)	(4,915,678.51)
Provisional credit for KBDC deposit of 10/17/86		4,041,479.64
Wire transfers in	4,000,000.00	4,000,000.00
	814,966.00	814,966.00
Miscellaneous credit	15.00	15.00
Closing balance 10/20/86	830,503.93	(274,496.07)

ORDER

Plaintiff in the above-captioned action has filed a timely motion for reconsideration of the court's order dated September 19, 1995, which granted defendant's motion for summary judgment on all three counts of plaintiff's second amended complaint. Plaintiff disputes the court's conclusion that defendant was a fully secured creditor at the time of the challenged wire transfer.

Plaintiff contends that, despite the court's allegedly erroneous valuation conclusion,[1] defendant had a limited security interest because collection and application had already occurred with respect to the deposited checks except for the Monday deposits of $1,105,000. This assertion disregards the court's analysis of the collection and settlement process.

Defendant received provisional credit from the clearinghouse at noon on the business day of submission. Under the statute, defendant had a security interest in these credits, which were proceeds of the deposited checks, until final settlement, which occurred at midnight on the second business day following the grant of provisional credit.

Plaintiff is essentially contending that the court should treat the security interest in the credit representing checks being collected as somehow being disbursed or eliminated because batches of other checks drawn on the debtor's account were also received. This assertion is inconsistent with U.C.C. § 4-210(c), which states that: "So long as the bank does not receive final settlement for the item ... the security interest continues to that extent and ... (3) the security interest has priority over conflicting perfected security interests in the item, accompanying documents or proceeds." Plaintiff offers no authority for allowing the receipt of checks drawn on an account prior to final settlement to extinguish or take priority over the bank's security interest.

Plaintiff's theory is also unsound in light of the presentment rules governing the October 17 and 20 transactions. Final settlement on the $4,316,464.52 October

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[1] Contrary to plaintiff's contention, the court did not assign a value to the checks deposited for collection. The court valued the proceeds only, and noted the potential difficulties in placing a value on the checks.

17 presentment and the $4,915,678.51 October 20 presentment did not occur until midnight on October 21 and 22, respectively. Until this time, UMB had an absolute right to return these items to the clearinghouse for full credit. U.C.C. § 4-301. At the time of the challenged wire transfer, therefore, UMB was free to return the presentments to the clearinghouse and realize upon its security interest.

The argument heretofore presented by plaintiff has been that checks in collection (kited checks) were the antecedent debt problem that the $4 million wire transfer was attempting to remedy. Much time and effort has been devoted to this subject. Plaintiff now transfers attention to checks presented for payment *from* the depositor, so that it would appear that a large overdraft was in prospect.[2] If the $4 million wire transfer were now to be considered an attempt to avoid a large overdraft on checks issued by the debtor, it successfully accomplished that purpose, and would not appear to be preferential in nature.[3] Accordingly, it is hereby

ORDERED that plaintiff's motion for reconsideration is DENIED.

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[2] Under this revisionist analysis, the security interest in the provisional credit simply remained unaffected until the credit became fixed by passage of the midnight deadline.

[3] The court does note, however, that plaintiff asserts an antecedent debt of several hours' duration. This issue, if timely presented, may be resolved on appeal. It was debated in sketchy briefing after judgment was entered.

SECTION 101 OF THE BANKRUPTCY CODE (11 U.S.C. § 101)

§ 101. Definitions.

In this title—

* * *

(5) "claim" means—

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

* * *

(12) "debt" means liability on a claim;

SECTION 547(b) OF THE BANKRUPTCY CODE (11 U.S.C. § 547(b))

§ 547. Preferences

(a) In this section—

(1) "inventory" means personal property leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw materials, work in process, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease;

(2) "new value" means money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law including proceeds of such property, but does not include an obligation substituted for an existing obligation;

(3) "receivable" means right to payment, whether or not such right has been earned by performance; and

(4) a debt for a tax is incurred on the day when such tax is last payable without penalty, including any extension.

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title [11 USCS §§ 701 et seq.];

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title [11 USCS §§ 101 et seq.].

(c) The trustee may not avoid under this section a transfer—

(1) to the extent that such transfer was—

(A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and

(B) in fact a substantially contemporaneous exchange;

(2) to the extent that such transfer was—

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms;

(3) that creates a security interest in property acquired by the debtor—

(A) to the extent such security interest secures new value that was—

(i) given at or after the signing of a security agreement that contains a description of such property as collateral;

(ii) given by or on behalf of the secured party under such agreement;

(iii) given to enable the debtor to acquire such property; and

(iv) in fact used by the debtor to acquire such property; and

(B) that is perfected on or before 10 days after the debtor receives possession of such property;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor —

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of —

(A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or

(ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or

(B) the date on which new value was first given under the security agreement creating such security interest;

(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title [11 USCS § 545]; or

(7) if, in a case filed by an individual debtor whose debts are primarily consumer debts, the aggregate value of all property that constitutes or is affected by such transfer is less than $600.

(d) The trustee may avoid a transfer of an interest in property of the debtor transferred to or for the benefit of a surety to secure reimbursement of such a surety that furnished a bond or other obligation to dissolve a judicial lien that would have been avoidable by the trustee under subsection (b) of this section. The liability of such surety under such bond or obligation shall be discharged to the extent of the value of such property recovered by the trustee or the amount paid to the trustee.

(e)(1) For the purposes of this section —

(A) a transfer of real property other than fixtures, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee; and

(B) a transfer of a fixture or property other than real property is perfected when a creditor

on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.

(2) For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made —

(A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time;

(B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or

(C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of —

(i) the commencement of the case; or

(ii) 10 days after such transfer takes effect between the transferor and the transferee.

(3) For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred.

(f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

(g) For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.

SECTION 550(a) OF THE BANKRUPTCY CODE (11 USC §550(a))

§ 550. Liability of transferee of avoided transfer.

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.